S. Garber, Inc. v. Commissioner, 51 T. C. 733 (1969)

Advance payments received by an accrual basis taxpayer without restrictions must be included in income in the year of receipt, even if the goods or services are to be provided in the future.

Summary

S. Garber, Inc. , a company selling fur pelts and custom-made fur coats, required advance payments from customers. The IRS determined that these payments should be included in income in the year received, not deferred until delivery. The Tax Court agreed, holding that unrestricted advance payments constitute income upon receipt. The court also denied deductions for estimated cost of goods sold and state sales tax in the year of receipt, as no sale had yet occurred and the tax liability had not attached. This case clarifies that under accrual accounting, unrestricted advance payments are taxable income in the year received, regardless of when the goods are delivered.

Facts

S. Garber, Inc. , incorporated in 1956, sold fur pelts wholesale and custom-made fur coats at retail. For the latter, it required advance payments from customers, which were deposited into its regular bank account without restrictions on use. These payments were recorded as liabilities on its books and reported as income only upon delivery of the completed garments. For the tax year ending January 31, 1963, S. Garber received $25,533 in advance payments, which it did not include in its income for that year. The IRS determined a deficiency, arguing these payments should be included in the year of receipt.

Procedural History

The IRS determined a deficiency in S. Garber’s income tax for the year ending January 31, 1963, asserting that the advance payments should be included in income in the year received. S. Garber petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court upheld the IRS’s determination, ruling that the advance payments were taxable income upon receipt and denying deductions for estimated cost of goods sold and state sales tax.

Issue(s)

1. Whether advance payments received by an accrual basis taxpayer for custom-made goods, deposited without restriction, must be included in income in the year of receipt.
2. Whether a deduction should be allowed in the year of receipt for the estimated cost of goods sold related to the custom-made goods.
3. Whether a deduction should be allowed in the year of receipt for the Illinois sales tax applicable to the advance payments.

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Holding

1. Yes, because the advance payments were received without restriction and under accrual accounting, all events had occurred that fixed the right to receive the income.
2. No, because no sale had yet occurred, and the goods remained in inventory, so no cost of goods sold could be deducted.
3. No, because the liability for the sales tax had not yet attached at the end of the taxable year.

Court's Reasoning

The court relied on established precedent that under accrual accounting, unrestricted advance payments are income in the year received. It cited cases like *American Automobile Association v. United States* and *Automobile Club of New York, Inc.* , which held that when funds are received without restriction, all events have occurred to fix the right to income. The court rejected S. Garber's argument that its accounting method of deferring income clearly reflected income, as the Commissioner has broad discretion to reject methods that defer prepaid income. The court also distinguished cases cited by S. Garber, noting that the possibility of refunds did not negate the income upon receipt. For the cost of goods sold and sales tax deductions, the court reasoned that no sale had occurred and the tax liability had not yet attached, so deductions were not proper in the year of receipt.

Practical Implications

This decision has significant implications for businesses receiving advance payments, particularly those using accrual accounting. It clarifies that such payments must be included in income in the year received if they are unrestricted, regardless of when the goods or services are delivered. This may affect cash flow planning and tax liabilities for businesses in industries like custom manufacturing or service contracts. The ruling also underscores that deductions for costs or taxes related to advance payments cannot be taken until the sale is complete and the tax liability is fixed. Later cases have followed this precedent, reinforcing the principle that unrestricted advance payments are taxable upon receipt. Businesses should carefully consider their accounting methods and the tax implications of receiving advance payments in light of this ruling.

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